Global Equity Views
Themes and implications from the Global Equity Investors Quarterly

In brief

Global equity markets are already down more than 20% this year, but our portfolio managers remain cautious. The wild boom unleashed by the fiscal and monetary policies put in place to address the impact of the pandemic is ending. Inflation is stubbornly high, interest rates are rising quickly in most regions, and economic growth is slowing. So far, corporate profits have held up very well, but we are not convinced that will continue in this more difficult economic environment.

Equity valuations have improved overall, and speculative behavior has faded fast. But despite severe declines, the prices of faster-growing companies are still quite demanding, while profit growth is slowing in the all-important technology sector. We focus closely on the quality of management teams and balance sheets across all industry groups.

Yet again this year, international stocks have underperformed U.S. equities, this time largely because of a strong U.S. dollar. But stocks in Europe and Asia now trade, on average, at a very wide discount to their U.S. peers, and eventually this will matter. This is no time to give up on international diversification.

Taking stock

After a brief summer rally, equity markets have once again weakened, and the underlying trends haven't improved. Our equity team remains fairly cautious on the outlook, with most expecting subpar returns to persist for a while. Both markets and the real economy are transitioning away from the wild boom triggered by the extraordinary fiscal and monetary stimulus unleashed in response to the COVID-19 pandemic. It is proving a difficult journey.

The economic backdrop looks increasingly challenging. With inflation stubbornly high in the U.S. and soaring in Europe, central banks have been increasingly aggressive in tightening monetary policy, and economic growth is cooling as policy tightens. So far, company earnings have held up very well, and our profit forecasts haven't changed much at all. After a jump of more than 50% last year, we see global profits rising another 7% this year and continuing to expand modestly in 2023. But the first cracks are starting to appear, and we are expecting more. Wage inflation, elevated commodity prices (especially in Europe) and slower growth all threaten the outlook.

At least some of these concerns are now reflected in equity market valuations, with the MSCI All Country World Index more than 20% below the peak levels of late last year. By region, the valuations of U.S. stocks are
slightly below the average of 17x price-to-earnings over the last 25 years. And with the rest of the world trading at only 11x expected earnings with a dividend yield of almost 4%, we see the widest gap between U.S. and non-U.S. stock valuations in decades.

Meanwhile, the frenzied speculation in many corners of the market that accompanied the pandemic boom has faded fast. The special-purpose acquisition company (SPAC) boom has come to a sudden halt, the “meme” stocks favored by individual traders have collapsed, and the “growth at any price” bubble (the biggest speculation) has also started to seriously unwind. There have been almost no IPOs in the U.S. market this year, a telling sign of much more cautious sentiment toward newer and unproven companies.

By style, the price of the fastest-growing companies has fallen 30%, on average, with much more severe declines for those yet to record a profit (Exhibit 1). While the valuations are far from cheap, we are now finding some opportunities in better-quality growth stocks. But as we wrote in our last quarterly, quality and predictability remain most highly prized by our investors as they manage money in this highly unpredictable environment.

Some interesting opportunities are already starting to appear. Asian stocks have fallen as fast as any region, and we do see some bargains. The Korean stock market, for example, now trades below book value, despite much improved corporate quality in recent years. We see the best expected returns for Chinese stocks over the next few years, but the near-term outlook is still very difficult. COVID-19 restrictions and long-standing problems in the real estate market are severely impacting the economy and corporate profits this year.

In a downturn, quality matters, in managements and balance sheets

Our near-term profit forecasts have changed only modestly in the last few months, with the positive impact of higher oil prices for the energy sector largely offsetting gradual weakness across most other industry groups. However, most of our portfolio managers expect things to get more difficult as we move into 2023 (Exhibit 2).

So far, our earnings forecasts have remained fairly consistent for 2022 and 2023

Exhibit 2: J.P. Morgan Asset Management analysts’ MSCI World EPS growth estimates, Jan 2022 vs. Sept 2022

This is especially true in Europe, where the war in Ukraine has had a dramatic impact on energy prices. German electricity prices, for example, are now 10 times the levels in the U.S. But so far, U.S. consumers remain in good shape, and there are some important offsets. For example, automobile production is still depressed by a shortage of components, while many industrial companies have order books up to 50% of current revenues vs. a more typical 20%–25%.
Previous downturns have taught us that quality – of management, balance sheets and the fundamental business – matters a great deal in a more difficult environment. There is no substitute for thorough fundamental research into each company and a cautious approach to available information. Seemingly robust order books can suddenly evaporate as customers get more nervous. Understanding balance sheets and funding needs becomes paramount.

For both businesses and stock prices, duration matters a lot right now. We have little interest in either very high valuations vulnerable to further increases in interest rates or unprofitable businesses several years from earning a return for their shareholders. As we look for more contrarian opportunities, we are starting with small positions and a willingness to be very patient.

Growth stocks: Still approach with caution

Once again, the outlook for the fastest-growing companies was a key focus of our Investors Quarterly. We conclude that while valuations are less extreme and sentiment less unrealistic, this group should still be approached with some caution. Valuations are still quite demanding in a historical context. And fundamentals are not quite as impressive as markets had priced in. More time is required to correct excessively optimistic assumptions.

Today, our growth managers find more opportunities in industrials and financials than in the technology sector that has dominated returns over the past decade. As always, our best advice to clients is to stay balanced among different styles and focus on finding the best managers within each space.

Is there any hope for international equities?

Yet again, international equities, long a staple of standard asset allocation, have lagged the U.S. market this year, despite weaker performance from the U.S.-dominated technology sector. Investors can be forgiven for wondering if the 14-year run of U.S. outperformance will continue indefinitely.

In our view, the advantages of the U.S. market are many and deep, but we wouldn’t give up on EAFE stocks at this point. European economies face a very tough winter, as energy costs have soared. But the companies that make up the indices are much more international and also benefiting hugely from a very strong U.S. dollar. The same is true in Japan, where a quiet but unmistakable shareholder revolution is in progress, improving returns for many listed companies.

Views from our Global Equity Investors Quarterly, September 2022

Exhibit 3

Source: A subset of results is shown from a September 2022 survey of Global Equity Investors Quarterly participants. These responses are taken from a quarterly survey representing 30 CIOs and portfolio managers across global equities.
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